DEPARTMENT OF STATE REVENUE

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LETTER OF FINDINGS NUMBER: 95-0621 ST
Sales and Use Tax
For The Period: 1992-1994

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ISSUES

I. **Sales/Use Tax -** Software Licensing Agreement

Authority: IC 6-2.5-3-2; IC 6-2.5-4-10; IC 6-8.1-3; 45 IAC 2.2-4-2; Information Bulletin No. 8 issued (Feb. 9, 1990)

The taxpayer protests the imposition of use tax on software licensing agreements.

II. **Sales/Use Tax -** Software Maintenance Agreements

Authority: IC 6-2.5-3-1; IC 6-2.5-3-2; IC 6-2.5-4-10; IC 6-8.1-3; Information Bulletin No. 2 issued (August 1991)

The taxpayer protests the imposition of use tax on software maintenance agreements.

III. **Sales/Use Tax -** Industrial Recovery Tax Credit

Authority: IC 6-3.1-11-12; Caylor-Nickel Clinic, P.C. v. Indiana Department State Revenue, 569 N.E.2d 768, (Ind.Tax 1991), aff'd (1992), Ind., 587 N.E.2d 1311

The taxpayer protests the auditor's denial of the application of the Industrial Recovery Tax Credit to the assessed sales and use tax deficiency in the audit.

IV. **Negligence Penalty** - Imposition

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

The taxpayer is not a registered retail merchant in the state of Indiana. The taxpayer remits use tax on its Form IT-20 instead of filing monthly ST-103 forms.

The taxpayer protests the assessment of use tax on licensed software and its software maintenance contracts. The taxpayer also contends that the Industrial Recovery Tax Credits it earned should be applied to the use tax assessed in the audit.

I. **Sales/Use Tax** - Software Licensing Agreements

DISCUSSION

The taxpayer protests the use tax assessed on the licensing (leasing) of computer software. Under IC 6-2.5-3-2 use tax is imposed on the "[s]torage, use, or consumption of tangible personal property in Indiana, if the property was acquired in a retail transaction…" unless an exemption is granted. The taxpayer asserts that it purchased a licensing agreement to use computer software, but did not lease tangible personal property in the form of computer software. Thus, the taxpayer believes there is no basis for imposing use tax. IC 6-2.5-4-10(a) states:

> A person... is a retail merchant making a retail transaction when he rents or leases tangible personal property to another person.

In the instant case, a license or lease agreement is tantamount to the renting or leasing of tangible personal property. Although the taxpayer is not acquiring ownership rights to the computer software, it is purchasing the right to use the software for a period of time.

The taxpayer cites the promulgated regulations of the State Board of Tax Commissioners, which state at 50 IAC 4.2-4-3 (g), that application software is nonassessable intangible personal property. The Indiana Code at 6-2.5 does not reference the regulations promulgated by the State Board of Tax Commissioners and instead adheres to Information Bulletin #8 (issued February 9, 1990) which classifies software as tangible personal property.

Also, the taxpayer challenges the validity of Information Bulletin #8 (issued February 9, 1990), stating that it was issued without statutory authority or proof of legislative intent and is non-binding on the Department. However, IC 6-8.1-3, gives primary responsibility to the Department for the administration, collection, and enforcement of the listed taxes. This, by way of necessity, includes the power to interpret the statutes governing the listed taxes.

Information Bulletin #8 was administered in a manner that is consistent with the authority granted to the Department. Therefore, the Department recognizes and follows the interpretation contained in Information Bulletin #8. The Department also recognizes that the taxpayer wants to recognize Information Bulletin #8 to the extent it finds the language favorable.

The taxpayer argues that the software at issue is exempt because it was customized for their use and cites Sales and Use Tax Information Bulletin #8, (hereinafter "bulletin") at Section II, part B, paragraph 1, which states the following:

> (t)ransactions involving computer software are not subject to Indiana Sales or Use Tax provided the software is in the form of a custom program specifically designed for the purchaser.

The Bulletin also states:

> Pre-written programs, not specifically designed for one purchaser, developed by the seller for sale or lease on the general market in the form of tangible personal property and sold or leased in the form of tangible personal property are subject to tax irrespective of the fact that the program may require some modification for a purchaser's particular computer. Pre-written or canned computer programs are taxable because the intellectual property contained in the canned program is no different than the intellectual property in a videotape or a textbook.

Under these two provisions, the taxpayer argues that its computer software purchases are not subject to sales and use tax because the software is customized and modified to the needs of its company. The taxpayer asserts that the software is a "shell" with little or no practical use before modification. In addition, the taxpayer asserts that it spends two to three times the shell price in assessing its use for the software and actually having the vendor company modify the software to fit its needs. Simply based on the quantity of time spent assessing and modifying, the modifications are "significant." Thus, the taxpayer argues that the software is a non-taxable "custom program" within the meaning of the bulletin.

The taxpayer's software, however, fails to meet the custom design exemption. As stated before, the Information Bulletin describes canned software as pre-written programs not specifically designed for *one* purchaser and developed for sale or lease on the general market. (Emphasis in original) In this situation, the software was a pre-written program, not specifically designed for one purchaser, and developed by the seller for sale or lease on the general industry market. Based on these facts, the base (shell) is the same as (canned software) and is tangible personal property.

The taxpayer's protest is denied and is subject to the use tax, however, the invoices on the purchases referenced in the audit as 1714667 and 1872269 show that sales tax was paid at the time of purchase. These two invoices should be removed from the proposed assessment.

FINDING

The taxpayer's protest is partially sustained and partially denied. The protest was partially denied in that the leasing of canned software is subject to the use tax. The protest is partially sustained as the two invoices, which show sales tax to be collected at the time of purchase, will be removed from the assessment calculation.

II. **Sales/Use Tax -** Software Maintenance Agreements

DISCUSSION

The taxpayer protests the assessment on an invoice listed as Intelus reference number 1827645 in the audit report. The taxpayer argues that this invoice was an optional maintenance agreement and not subject to use tax.

Use tax is imposed on the storage, use, or consumption of tangible personal property in Indiana, if the property was acquired in a retail transaction. IC 6-2.5-3-2. A retail transaction occurs when a retail merchant, in the ordinary course of its business, acquires tangible personal property for the purpose of resale and transfers that property to another for consideration. IC 6-2.5-4-1.

Information Bulletin #2 outlines the Department's position on maintenance agreements:

> Optional warranties and maintenance agreements are not subject to tax because the purchase of the warranty or maintenance agreement is the purchase of an intangible right to have property supplied and there is no certainty that property will be supplied.
>
> However, if the agreement includes a charge for property to be periodically supplied, the agreement would be subject to tax.

The assessment at issue here was a separate consideration from the original software purchase and was billed on a separate invoice. It is an optional maintenance agreement and not an exchange of tangible personal property; consequently, it is not subject to the use tax.

FINDING

The taxpayer's protest is sustained. The optional maintenance agreement is not subject to the use tax.

III. **Sales/Use Tax -** Industrial Recovery Tax Credit

DISCUSSION

The taxpayer is not registered to collect sales tax and does not file ST-103 forms. The taxpayer reports its use tax due on the corporate income tax, IT-20 form. The taxpayer asserts that it is entitled to carry forward industrial recovery credits to offset its sales/use tax liability since it is reported on its IT-20 form.

The taxpayer argues that the instructions to Form IT-20 require that "Line 49, Total income tax", and (Line 50, Sales/Use tax due from Consumer's Use Tax Worksheet) be added and reported as "Line 51 subtotal." Taxpayer protest letter, p. 4. The taxpayer states that all credits, such as the industrial recovery tax credit are included on (Line 55, Total tax reduction.) The taxpayer notes that amounts reported on Line 55 as last determined or reported for the years audited exceeds the amount of sales and use tax deficiencies assessed. Id. The taxpayer concludes that the auditor should have applied these credits against the use tax when adjusting the audit assessment.

IC 6-3.1-11-12 outlines which tax sections are affected by the Industrial Recovery Tax Credit:

> As used in this chapter, (state tax liability) means the taxpayer's total tax liability that is incurred under:
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> (1) IC 6-2.1 (the gross income tax);
> (2) IC 6-3-1 (the adjusted gross income tax);
> (3) IC 6-3-8 (the supplemental net income tax);
> (4) IC 6-5-10 (the bank tax);
> (5) IC 6-5-11 (the savings and loan association tax);
> (6) IC 27-1-18-2 (the insurance premiums tax);
> (7) IC 6-5.5 (the financial institutions tax);
>
> as computed after the application of the credits that, under IC 6-3.1-1-2, are to be applied before the credit provided by this chapter.

The Industrial Recovery Tax Credits is to be applied to tax liabilities that are enumerated in the above-listed statute. Neither the sales tax nor the use tax statute is included in the taxes that the credits are eligible to be applied against.

The Indiana Tax Court in Caylor-Nickel Clinic, P.C. v. Indiana Department State Revenue, 569 N.E.2d 768, (Ind.Tax 1991), aff'd (1992), Ind., 587 N.E.2d 1311, recognized that the Legislature's inclusion of a condition in some exemption statutes, but not others, must be respected:

There is a strong presumption that the legislature, in enacting a statute, has full knowledge of existing legislation on the same subject matter. Id. at 769.

Even though a tax credit is involved instead of an exemption as in the Caylor-Nickel case, the taxpayer's situation is analogous. If the legislature had intended for the Industrial Recovery Tax Credit to be applied to sales and use tax, it would have listed it in the statute.

FINDING

The taxpayer's protest is denied. The statute does not allow the Industrial Recovery Tax Credit to be applied to a sales/use tax liability.

IV. **Tax Administration** - Penalty

DISCUSSION

Taxpayer protests the imposition of the ten percent (10%) negligence penalty. The negligence penalty imposed under I.C. 6-8.1-10-2.1 may be waived by the Department where reasonable cause for the deficiency has been shown by the taxpayer. Specifically:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-2 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. 45 IAC 15-11-2(e).

The taxpayer believed that the software was customized because of the modifications made to the original product. The taxpayer read Information Bulletin #8 and believed that it was entitled to the exemption for custom software because of the modifications. Due to these circumstances, the taxpayer has established reasonable cause for its interpretation of the law. The taxpayer's protest is sustained as to this issue.

FINDING

The taxpayer's protest is sustained. The ten percent (10%) negligence penalty will be waived.